ARTICLES

ERWIN P. EICHMANN*

Legal Aspects of Doing Business in Hungary**

The recent events in Eastern Europe have spurred Western firms to invest money into what once was a moribund economic region. Recent corporate and joint venture legislation in Hungary, in particular, coupled with economic and political reforms, has opened up a new market for Western goods and a new basis for the manufacture of exports to the European Economic Community. In the present climate foreign firms can find numerous opportunities for profitable medium- and long-term investment. Despite the tremendous progress made over the past years, however, investing in Hungary still requires the surmounting of several economic and bureaucratic hurdles. One can only hope these will be alleviated as the pace of reform accelerates.

Even before its transition to a democratically-elected government, Hungary had enacted market-based corporate and foreign investment laws as a step towards attracting Western capital. The laws establish straightforward procedures for the establishment of joint ventures, granting them specific economic rights to conduct business and allowing the free repatriation of their profits, regardless of whether the profits were made in convertible or nonconvertible currency. In short, the old government prepared a legal regime to accommodate Western investors.

*B.A., Yale University, 1986; J. D., Stanford Law School, 1989. The author is an associate in the Washington, D.C. office of O'Melveny & Myers.

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It is up to the new government, though, to implement the economic measures necessary for these investments. Hungarian companies labored under a centrally planned economic regime for decades, and the gradual reforms have not yet filtered throughout the system and created an entirely free market. While the institution of further reforms may inflict substantial uncertainties for new ventures in Hungary, these economic reforms will provide the actual substance for the legal rights currently enumerated only on paper.

Although Hungary's economic and legal reforms began over two decades ago with the 1968 New Economic Mechanism, Hungary only recently quickened the pace of liberalization and implemented a quasi-free market system with a sufficient economic infrastructure to attract Western investment.[1] Hungary's appeal for foreign capital lies in its low labor costs, highly-skilled work force, proximity to Western European markets,[2] and sales experience with hard currency markets.[3] To further induce the flow of foreign capital, Hungary enacted a legal and tax regime that grants substantial incentives for joint ventures with foreign participation. By July 1990, an estimated 1,800 joint ventures were operating, a

1. The New Economic Mechanism attempted to introduce market incentives and decentralization into Hungary's socialist central-planning regime back in 1968. These economic reforms have had their starts and stops over the years, and the state sector still runs an estimated 70 percent of the economy. Instead of privatizing their state sector, the former Communist government tried to make their state-owned enterprises simulate free-market conditions. For example, the central plan was abolished, and managers, elected by each company's employees, were told to negotiate with the state over production targets, price levels, and capital investment. If profits increased, the managers received bonuses. *See, e.g., East Europe Tries a Mild Capitalism,* N.Y. Times, Dec. 11, 1989, at D1.

In terms of legal reform, although Hungary technically permitted foreign equity stakes in joint ventures since 1972, few Western investors established new businesses prior to the amendment of Hungary's joint venture laws in 1979, 1984, and 1985. *See* Eichmann, *Joint Ventures in Hungary: A Model for Socialist States?,* 20 LAW & POL'Y INT'L BUS. 257 (1988). Passage of the Foreign Investment Act of 1988 strengthened the incentives for the introduction of foreign capital and provided the current basis for the attractiveness of Hungary.

2. General Motors, for example, is investing in an engine plant in northwestern Hungary; not uncoincidentally, General Motors has an existing plant across the border in Aspern, Austria. Lublin, *GM Pioneers Eastern Europe for Venture,* Wall St. J., Jan. 11, 1990, at A1.

3. As a small country (population 10.6 million) with few natural resources, Hungary relies on international trade to provide its needs in many sectors. This reliance on foreign trade has led Hungary to become responsive to Western markets.

Hungary already conducts most of its trades in hard currency. Only 40 percent of Hungary's trade goes to nonconvertible, Council for Mutual Economic Assistance (CMEA) markets and that percentage should rapidly fall as the CMEA countries shift to hard-currency accounting. *East Europe's Market Shift Will Take Time, Hungary's Berend Says,* Reuter's Library, Feb. 2, 1990.

Recognizing its need for access to Western markets, Hungary has joined in numerous international trading and financial organizations, including the International Monetary Fund, the International Bank for Reconstruction and Development (the World Bank), the International Finance Corporation, the General Agreement on Tariffs and Trade (GATT), and the World Intellectual Property Organization. Eichmann, *supra* note 1, at 276. Furthermore, Hungary was one of the first Eastern European countries to sign a comprehensive trade agreement with the European Economic Community (EEC) to improve its access to EEC markets. Council Decision of Nov. 21, 1988 concerning the conclusion of an Agreement between the European Economic Community and the Hungarian People's Republic on Trade and Commercial and Economic Cooperation, 31 O.J. EUR. COMM. (No. L 327) 1 (1988).

sixfold increase over the past year.[4] Foreign capital involvement is estimated at $700 million, with about half the joint ventures engaged in manufacturing and the other half in service and trading activities.[5]

Three pieces of recent legislation contribute to Hungary's attractiveness to foreign capital. The Economic Associations Act[6] provides the framework for private enterprise in Hungary and creates a "more or less level playing field for state and private businesses."[7] The Foreign Investment Act[8] allows foreign investors to establish joint ventures with Hungarian partners, or even with Hungarian companies outright, and then grants tax incentives to encourage such investment. Finally, the Transformation of Economic and Business Organizations and Companies Act[9] permits the privatization of state enterprises and envisions foreign ownership of these privatized companies.[10] Since most interest in Hungarian investment will result in joint ventures or wholly-owned companies, this article principally examines the Foreign Investment Act and its foundations in the Company Act.

4. *Number of Joint Ventures in Hungary Soar Sixfold in Year,* Reuter Bus. Rep., July 3, 1990.

5. *Id.*

6. Act VI of 1988 [hereinafter Company Act]. For an English translation, see HUNGAROPRESS (special edition, undated), published by the Information Service of the Hungarian Chamber of Commerce.

7. *Business Outlook Abroad,* Bus. America, Nov. 6, 1989, at 20.

8. Act XXIV of 1988 [hereinafter FIA]. For an English translation, see 1–2/1989 NATIONAL BANK OF HUNGARY, MARKET LETTER.

9. Act XIII of 1989. For an English translation, see HUNGAROPRESS (special edition, Oct. 1989).

10. The privatization law offers many intriguing investment possibilities in existing state-owned companies. Hungary could privatize $32 billion of state assets, and the State Property Agency plans to sell 100 to 150 enterprises (worth $2 billion) by the end of 1991. Vardy, *Western Brokers Rush to New Pastures in Excommunist Hungary,* The Reuter Library Rep., July 4, 1990; Lewis, *Hungarian Agency Outlines Expansive Privatization Plan,* Reuter's Library, May 3, 1990.

If an outside investor is willing to subscribe to at least 20 percent of the company and the company's management agrees with the privatization, then a foreign investor can buy up to 80 percent of the company. Hungarian Chamber of Commerce, *Introduction to Act XIII of 1989,* HUNGAROPRESS, Oct. 1989, at iii. The major difficulty with privatization is reaching an accurate (and politically acceptable) valuation of the company. For example, the proposed management buy-out of Apisz, a chain of stationary stores, was cancelled amid charges that Apisz's managers were trying to make a profit by undervaluing the company. *East Europe Tries a Mild Capitalism, supra* note 1. Eventually, the company was sold to an outside investor, at a remarkably low price, equal to one-third of its annual profits. Greenhouse, *East Europe's Sale of the Century,* N.Y. Times, May 22, 1990, at D5. Hungary has reacted by tightening the procedures for privatization. *See* Act on the State Property Agency and the Management and Utilization of its Property Share, Act VII of 1990.

The privatization of state enterprises has stirred much controversy in Hungary, over pricing and ownership issues. Leading members of the Hungarian Democratic Forum, the dominant party in Parliament, have described the sale of IBUSZ, a travel company, as "scandalous" because shares were floated partially on the Vienna Stock Exchange, where Hungarians could not buy, and quickly tripled in price, evidencing an extreme undervaluation of the company. Denton, *Hungarian State Body Attacked on Privatization,* Fin. Times, July 6, 1990, at 2. With little oversight, foreign investors struck deals with outgoing (communist) managers, giving them generous golden parachutes in return for undervaluation of the assets. If the privatization process continues to be seen as corrupt, political pressure may mount to stop it.

Foreign investors may obtain additional information on joint ventures in Hungary from a number of sources (for a list of addresses, see Annex One). InvestCenter, a state agency with a central office in Budapest and representatives in Hungary's major embassies, will coordinate and matchmake between the foreign investor, potential joint venture partners, and the Hungarian government, and will obtain all the necessary approvals. Trade Inform, the Office for Trade and Services sponsored by the Ministry of Trade, maintains a data base with credit reports of Hungarian companies and will provide details on local banking, legal, and tax regulations.[11] Further assistance may be received from the Hungarian Chamber of Commerce's Joint Venture Club or through retention of local counsel.

I. Founding a Joint Venture

The Foreign Investment Act allows a wide range of foreign and domestic entities to own equity in joint ventures, to buy shares of existing corporations, or to own Hungarian enterprises outright (hereinafter all forms will be referred to as joint ventures). Foreigners may participate in joint ventures only if they are "a firm according to their domestic law or if they are registered in a register of firms or any other economic register."[12] In contrast, any foreign natural person or legal entity may own shares in a Hungarian company.[13] On the Hungarian side, legal and natural persons, existing corporations, and the Hungarian state may engage in joint ventures with foreigners.[14]

Hungary now allows joint ventures to carry out "any economic activity" unless otherwise limited by domestic law.[15] The reference to domestic law has little impact, though, as current legislation does not reserve any sector for the state.[16] However, in several sectors (for example, banking) any company, Hungarian or domestic, must first receive permission from the state before it may begin.[17] Joint ventures with foreign participation have two great advantages over domestic enterprises. First, while domestic enterprises may not employ more than five hundred people,[18] joint ventures that are more than 50 percent owned by foreigners have no restrictions on the number of people they may employ.[19]

11. Rolfe, *Flourishing Joint Ventures*, INSTITUTIONAL INVESTOR, Sept. 1989, at S7.

12. FIA, *supra* note 8, art. 7. *See also* Company Act, *supra* note 6, § 7(1).

13. Company Act, *supra* note 6, § 7(1).

14. FIA, *supra* note 8, art. 8.

15. *Id.* art. 9(1). The Foreign Investment Act itself, though, contains two limits on joint venture activity. First, "[a] public company limited by shares which is fully or majority owned by foreigners may not acquire the majority of shares in another public company limited by shares." *Id.* art. 4(2). In addition, foreigners may not own bearer shares. *Id.* art. 13(2).

16. Rolfe, *Foreign Capital Welcome*, INSTITUTIONAL INVESTOR, Sept. 1989, at S9 (interview with Dr. Andres Patko, then deputy Minister of Finance).

17. Nevertheless, of the twenty private banks in Hungary, four include foreign joint venture partners. *Liberated Bankers Must Learn Fast*, EUROMONEY, Sept. 1989, at 118.

18. Company Act, *supra* note 6, § 10(1).

19. *Id.* § 10(2).

Second, joint ventures that include foreign investors receive significant tax breaks.[20] Thus, Hungarian entrepreneurs have a large incentive to find foreign backing in order to escape from the five-hundred-employee limit and reap the tax advantages.

Government authorization for foreign equity investments has been greatly simplified. Where the foreign stake does not exceed fifty percent, Hungary requires no special license for founding or entering a joint venture.[21] Instead, a foreign minority owner need only register with the Court of Registration.[22] For majority acquisitions in a joint venture foreigners must receive a joint license from the Minister of Finance and the Minister of Commerce.[23] The Foreign Investment Act enumerates a straightforward procedure for obtaining such a joint license. The appropriate party[24] must file five Hungarian-language copies of the application with the Minister of Finance[25] and must include the following information:

(a) the Hungarian and foreign members' names and domiciles;
(b) the company's form, place of registration, domicile, and scope of its activity;
(c) the amount of the company's assets and, for the establishment of a new enterprise, the company's planned assets;
(d) the manner of posttax profit distribution;
(e) the outlines of the enterprise's business plan (including data suitable for assessment); and
(f) a Hungarian-language copy of the new company's "Contract of Association" or the modification of the contract of a functioning company.[26]

Although approval of a joint license is discretionary, the process is not subject to delay.[27] The Minister of Finance must issue the joint decision on the application within ninety days; otherwise, the license is deemed to be granted.[28] Moreover, if the minister rejects the application, he must give reasons for the rejection.[29]

20. *See infra* text accompanying notes 93–106.

21. FIA, *supra* note 8, art. 9(3); Company Act, *supra* note 6, § 8(2).

22. Rolfe, *supra* note 16.

23. FIA, *supra* note 8, art. 9(2); Company Act, *supra* note 6, § 8(1).

24. The application should be filed by the Hungarian partner when establishing a new corporation, by the foreign partner when founding a wholly owned enterprise, or by the existing Hungarian corporation for a foreign acquisition of shares. FIA, *supra* note 8, art. 10(2). In addition to all other required information, where a foreign investor applies for full ownership of an enterprise, the application must indicate a party for the service of documents. *Id.*

25. *Id.* arts. 10(1)–10(2).

26. *Id.* arts. 10(3)–10(4).

27. Prior to the law's passage, the average delay for registration of joint ventures had been six months. *Top Hungarian Official Sees Recovery Ahead,* 17 BUS. E. EUR. (BUS. INT'L), Nov. 28, 1988, at 377. However, if an application is filed incorrectly, the applicant may still be requested to remedy the error within thirty days of the original filing, after which the ministries will have sixty days to decide on the application. FIA, *supra* note 8, art. 11(2).

28. FIA, *supra* note 8, art. 9(2).

29. *Id.* art. 11(1).

Foreign investors can contribute most types of assets for the acquisition of an equity stake. They may make in-kind contributions of "any negotiable asset with real value, any intellectual property, [or] any valuable right."[30] However, foreigners may only contribute cash in hard currency unless an international treaty stipulates otherwise.[31]

II. Corporate Law Provisions Affecting the Founding of Joint Ventures

Before registering as an economic association,[32] the joint venture must first satisfy the conditions of the Company Act. The Company Act provides the legal framework for all private investment in Hungary, both foreign and domestic, and is patterned after German and Austrian corporate law. Since most foreign investors establish their joint ventures either as limited liability companies or as companies limited by shares, this article examines only these two corporate forms.[33]

Under the previous law, foreign investors generally formed joint ventures as limited liability companies.[34] A foreign investor may utilize either corporate form because differences between them have little effect on the operations of a joint venture. First, the minimum capitalization of a company limited by shares is slightly higher than that of a limited liability company; ten million forints (approximately U.S. $150,000), rather than one million forints (approximately U.S. $15,000).[35] Many foreign investors initially capitalize their joint ventures at under ten million forints, so this difference is not insignificant.[36] Second, only the shares of a company limited by shares may be traded on a stock exchange; in contrast, the shares of a limited liability company must be offered to the other shareholders before nonmembers may buy them.[37] However, as the Budapest stock market has a low capitalization and very thin trading, foreign investors

30. *Id.* art. 12(2).

31. *Id.* The U.S.-Hungary bilateral trade agreement may allow contributions in soft currency by stating that "[f]inancial transactions between firms, enterprises and companies of the two countries shall be carried out in United States dollars or any other freely convertible currency *unless the parties to the transaction agree otherwise.*" U.S.-Hungary Bilateral Agreement, *infra* note 111, art. IV(2).

32. Hungarian law follows the civil law concept that businesses are formed by a contract of association, rather than the Anglo-American concept of a state-granted charter. Thus, the Company Act prescribes rules for the partner's assumed freedom to contract, rather than detailing the powers of the corporation, its officers, and directors. Beggans, *The Hungarian Economic Associations Act of 1988: Democracy in a Corporate Nutshell,* INT'L PRAC. HANDBOOK NO. 44, 1989, at 5.

33. Overseas Private Investment Corporation (OPIC), *Investing in Poland and Hungary* (July 6, 1989) (unpublished manuscript). The limited liability company corresponds to the Gesellschaft mit beschränkter Haftung (GmbH or Ges.m.b.H.) under German law, and the company limited by shares corresponds to the Aktiengesellschaft (AG).

34. W. KUIPER, (EAST-WEST) JOINT VENTURES: A SPECIAL PHENOMENON IN INTERNATIONAL TAX LAW? 121 (1988).

35. Company Act, *supra* note 6, §§ 158(2), 251.

36. Eighty-five percent of the joint ventures formed in the first quarter of 1990 were capitalized at under ten million forints. *Number of Joint Ventures in Hungary Soar Sixfold in Year, supra* note 4.

37. Company Act, *supra* note 6, § 171(1).

generally do not list their shares on it.[38] As for listings on other exchanges, only one Hungarian company is listed abroad, on the Vienna exchange.[39]

A. RULES COMMON TO BOTH FORMS

To create either type of company, the investors must draft and sign a founding document, known as a deed of association for limited liability companies or the articles of association for companies limited by shares.[40] This founding document must include the following information:

(a) the company's name and domicile;
(b) the names of the company's members and their domiciles;
(c) the company's scope of activity;
(d) the size of the company's assets and the date and manner of their availability;
(e) everything else required by the Company Act for individual forms of association; and
(f) the term of the company, if less than an indefinite period.[41]

Within thirty days of concluding the document, the parties must notify the Court of Registration and comply with the court's statutory rules; however, once the court registers the company, the company begins life retroactive to the conclusion of its founding documents.[42] The registration should be processed within five to six weeks.[43]

Every company limited by shares and every limited liability company with primary capital of over fifty million forints (approximately U.S. $750,000) must appoint an auditor.[44] The company's auditor must be chosen from the list of chartered auditors and cannot be the company's founder, a shareholder, an executive officer, a supervisory board member, or any close relation of those people.[45]

38. Bandy, *Eastern Europe's First Stock Exchange Opens in Budapest,* Associated Press, June 22, 1990 (only 41 companies were listed on opening day); Hamilton, *Hungary's Stock Market Has Same Woes as Capitalist Countries,* L.A. Times, Sept. 5, 1989, at D1 (detailing problems of the trial phase of the exchange).

39. Denton, *supra* note 10.

40. Company Act, *supra* note 6, §§ 19(1)–19(2). This founding document must also be endorsed by a barrister or company attorney. *Id.* § 19(2).

41. *Id.* §§ 21(1), 21(3). If any one of items (a)-(e) is missing, the founding document is deemed null and void. *Id.* § 21(2).

42. *Id.* §§ 23(1)–23(2), 24(1). The company must also register the names and addresses of each member of its supervisory board and its auditor. *Id.* § 34. All changes to the founding documents or the information pertaining to the company's supervisory board or auditor must be registered with the court. *Id.* § 23(3).

43. OPIC, *supra* note 33.

44. Company Act, *supra* note 6, § 39(2).

45. *Id.* § 40. "Close relation" is defined by § 585(b) of the Civil Code. In addition, none of these listed persons may serve as the company's auditor for three years following the termination of their membership quality. *Id.*

For a limited liability company owned by more than one person, a supervisory board of at least three people is required when: (a) the company's primary capital exceeds twenty-five million forints (approximately U.S. $375,000); (b) the company has more than twenty-five shareholders; or (c) the company has an annual average of more than two hundred full-time employees.[46] If a supervisory board is required because of clauses (a) or (b) above, the first supervisory board must be appointed in the company's deed of association.[47]

Every company limited by shares must have a supervisory board with three to fifteen persons.[48] The shareholders may elect the entire supervisory board unless the company employs an annual average of more than two hundred persons, in which case the employees shall elect one-third of the supervisory board.[49]

B. Rules for Limited Liability Companies

The Company Act defines a limited liability company as "an association constituted with a primary stock consisting of predetermined primary stakes, in which the member's liability towards the company is limited to providing his primary stake and other material contributions—if any—defined in the deed of association."[50] A limited liability company must have a minimum founding capital of one million forints (approximately U.S. $15,000), of which the cash component must be at least thirty percent and at least 500,000 forints (approximately U.S. $7,500).[51] Each member must contribute at least 100,000 forints (approximately U.S. $1,500), and at least half of each member's contribution must be paid in before the company may register.[52]

The limited liability company's founding document is known as a deed of association. The deed of association must include, in addition to the information required of all companies, the following information:

(a) the amount of the primary stock and each member's primary stake;
(b) if any money stake is not fully paid, the manner and date of payment;
(c) the extent of the voting rights and the procedure to be followed in case of a tie vote;
(d) the name of the first managing director or, in the case of several managing directors, the system of management, representation, and the manner of signing the firm's name;

46. *Id.* § 208(2). In a limited liability company owned by one person, a supervisory board is only required if the number of full-time employees exceeds two hundred on an annual average. *Id.* § 208(3).
47. *Id.* § 210(1).
48. *Id.* § 291(1).
49. *Id.* §§ 291(2), 292.
50. *Id.* § 155(1).
51. *Id.* §§ 158(2), 160.
52. *Id.* §§ 159, 161(2).

(e) the members of the first board if the company is required to have a supervisory board; and
(f) the name of the first auditor if the company is required to have an auditor.[53]

Once the founders draft and sign the deed of association, they may apply for registration of the company.

C. Rules for Companies Limited by Shares

The law defines a company limited by shares as "an economic association formed with a registered capital consisting of shares of predetermined amount and nominal (face) value, in which the member's (shareholder's) liability towards the company is limited to supplying the face value or value of the issue of the share."[54] A company limited by shares must have a minimum founding capital of ten million forints (approximately U.S. $150,000), of which the cash component must be at least thirty percent and at least five million forints (approximately U.S. $75,000).[55] Before registering a company limited by shares, the founders must draft a deed of foundation, arrange to underwrite the registered capital,[56] convene a statutory meeting, and substantiate that at least 30 percent of the registered capital has been paid in.[57]

The founders must first draft a deed of foundation and have it certified by a notary public.[58] The deed of foundation must include the following information:

(a) the company's name, domicile, scope of activity, and term;
(b) the intended size of the registered capital;
(c) the number and nominal value of the shares, as well as their value at issue and, in the case of various types of shares, their character and the rights attaching to each type;
(d) the place and starting and final day of share subscription;
(e) the priorities granted to the founders, and in particular, whether they may appoint the board of directors for the first three years;
(f) the subject-matter and value of nonpecuniary contributions and number of shares to be given in consideration, the name and domicile of each

53. *Id.* § 157(1).
54. *Id.* § 232(1).
55. *Id.* § 251.
56. For the purposes of this article it is assumed that the founders agree in writing to acquire all the shares in proportions defined by them and endorse the writing by a barrister or attorney-at-law. If so, they may form the company through the provisions for foundation *in camera*, *Id.* § 260, whereby the deed of foundation need not be released, nor a subscription of shares be held. Though § 260(1) explicitly states that the founders need not hold a statutory meeting for foundation *in camera*, since § 262 only allows the registration of a company limited by shares after the convocation of such a statutory meeting, the provisions for a statutory meeting are provided.
57. *Id.* § 262.
58. *Id.* § 252(2).

contributor, and the name of the auditor performing the preliminary valuation;[59]

(g) the procedures in case of over-subscription; and

(h) the manner of convoking the statutory meeting.[60]

The statutory meeting can then establish the articles of association and must undertake various foundational proceedings.[61] The Company Act requires the articles of association to include the following information:

(a) the company's name and domicile;

(b) the company's term and scope of activity;

(c) the size of the registered capital and payment terms for the shares;

(d) the shares' number and nominal value and whether they are bearer's shares or registered shares;

(e) the manner of signing the company's firm name;

(f) the manner of calling the shareholders' meeting, its quorum and the proceedings in case of a lack of quorum, and the terms and manner of exercising voting rights;

(g) the number of members of the board of directors, the supervisory board, and the company's auditors, their manner of election, their powers, and the duration of their offices;

(h) the rules of profit distribution;

(i) the means of publishing the company's bulletins; and

(j) the sanction for failure to pay up the shares.[62]

After completion of these acts and documents, the board of directors may finally announce the company's establishment to the Court of Registration. Concurrently, the board must substantiate that the statutory meeting was properly convened, that the subscribers underwrote all the registered capital, and that at least 30 percent of the registered capital has been paid in.[63] Once all these steps are accomplished, the company's application for registration is complete.

III. Operating a Joint Venture

Hungary allows the joint venture the widest possible economic freedom by simply granting it the same treatment as any private or state-owned Hungarian domestic enterprise. Nevertheless, the Foreign Investment Act grants the joint

59. In addition, the founders must disclose the data upon which the value of the nonpecuniary contribution was established and must base its value on the previous determination of the auditor. *Id.* § 253.

60. *Id.* § 252(3).

61. The statutory meeting must state that the registered capital was fully subscribed and that at least 30 percent has been paid in, approve the company's constitution and any agreements concluded before the meeting, evaluate any nonpecuniary contribution, and elect the board of directors, the supervisory board, and the company's auditor. *Id.* § 258.

62. *Id.* § 261(1).

63. *Id.* § 262(1).

venture numerous specific rights, including the right to purchase and sell commodities,[64] set prices according to market conditions,[65] engage in wholesale, retail, and foreign trade,[66] engage in foreign exchange transactions,[67] acquire ownership or other real estate rights,[68] freely trade its assets,[69] and take out loans and make payments.[70] In addition, the joint venture must follow domestic legislation and pay social insurance on the wages of its Hungarian employees,[71] observe the Hungarian Labor Code,[72] maintain proper statistics and accounts in Hungarian forints,[73] obey provisions relating to unfair business practices, unfair pricing, and quality protection for goods and services,[74] and be subject to compulsory liquidation in the case of lasting insolvency.[75]

While these provisions simplify the structure of the Foreign Investment Act, they also necessitate a close examination of domestic legislation and the depth of ongoing economic reforms. In particular, foreign investors should ascertain the type of pricing, the availability of raw materials, and the type of market for their sales. While the government is committed to price liberalization, many prices remain state-controlled. For example, cars, gasoline, heating fuels, medicines,

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64. FIA, *supra* note 8, art. 20(1).

65. *Id.* art. 20(2).

66. *Id.* art. 21. Rejecting its prior regime of state monopolization of foreign trade, Hungary now grants all economic organizations, including joint ventures, the statutory right to engage directly in foreign trade, subject only to formal registration with the Ministry of Trade; however, the Ministry of Trade must approve all trade with nonconvertible currency (mainly CMEA) markets and trade in goods on the list of "exceptions." Decree No. 1/1987 (XX.29) of the Ministry of Trade, *modified by* Decree No. 1/1989 (I.18) KeM of the Ministry of Trade, *described in* Naray, *The End of the Foreign Trade Monopoly: The Case of Hungary,* 23 J. WORLD TRADE (No. 6) 85, 92–93 (1989). From January 1989, 40 percent of convertible currency imports had been allowed to be imported without license, Decree No. 12/1988 (XII.27) KeM of the Ministry of Trade, *described in* Naray, *supra,* and that percentage has increased to 65 percent. Remarks of Tamas Beck, then Minister of Trade, Columbia Institute Congressional Conference, *Business Prospects and Opportunities: Deciding When to Invest and Build New Markets in Eastern Europe and the Soviet Union,* May 21, 1990, Federal News Service (available on NEXIS). The percentage is expected to increase to 80 percent by the end of 1990, U.S. DEP'T OF COM., FOREIGN ECONOMIC TRENDS 3 (Sept. 1989). In addition, from January 1, 1991, all trade with the Soviet Union will be conducted in hard currency. Remarks of Tamas Beck, *supra.*

67. FIA, *supra* note 8, art. 31(1).

68. *Id.* art. 19(a).

69. *Id.* art. 19(b).

70. *Id.* art. 23.

71. *Id.* art. 26(1).

72. *Id.* art. 28(1). Hungarian wages remain low, especially in comparison to the good educational level of the population. One estimate puts the standard factory wage at only $1.43 per hour, inclusive of benefits. Arndt, *A Lot is Riding on Tandem of Schwinn and Hungary,* Chicago Trib., Dec. 24, 1989. If, however, foreign participation exceeds 20 percent or five million forints (approximately U.S. $75,000), the joint venture need not follow domestic wage or incentive restrictions for its "leading officials" and can pay them whatever it pleases. FIA, *supra* note 8, art. 29.

73. Joint ventures in a customs-free zone may instead keep their books in a convertible currency. FIA, *supra* note 8, art. 30. *See infra* section VI.

74. FIA, *supra* note 8, arts. 20(2), 22.

75. *Id.* art. 25.

and public utilities are under state control, while most foodstuffs, beverages, durable goods, and textiles are governed by market forces.[76] Moreover, Hungary plans to phase out subsidies over the next two years, which may lead to higher electricity prices and an increase in inflation.[77] Thus, if the firm's raw materials or sales involve price-controlled markets, the potential investor should be wary of using the firm's historical performance as an indicator of future profitability because relative prices could change dramatically in a market undistorted by subsidies. In addition, investors should carefully examine the financial health of their Hungarian suppliers and customers because many state and cooperative enterprises are operating at a deficit and could go bankrupt after the withdrawal of state subsidies.[78] Further, Hungary has and will continue to decrease the subsidization of consumer goods and ailing state enterprises to meet the lending conditions of the International Monetary Fund.[79] Profitability studies, which depend on current raw material and sales pricing and availability, should include estimates of the effects of upcoming political decisions.

As for availability of foreign goods, Hungary has not abolished all of its import regulations. The Minister of Commerce's permission is needed for most imports, and requests for hard-currency imports are closely monitored.[80] Nevertheless, 65 percent of imports encounter no restrictions, and this free class includes the raw materials for most production activity. Hungary plans to liberalize imports further so that 80 percent of imports will be free of regulation by the end of 1990.[81] At the same time, any such plans for import reform depend on Hungary's remaining free from severe debt repayment difficulties in the future.[82]

IV. Potential Foreign Exchange Problems

The Foreign Investment Act attempts to assuage investors' foreign exchange fears and explicitly states that the foreign partner's profits can be "freely transferred abroad in the currency of investment," regardless of whether the joint venture has any export sales.[83] Further, provisions of U.S. law, Hungarian law,

76. *The Road to a Market Economy,* INSTITUTIONAL INVESTOR, Sept. 1989, at S3.

77. Carrington, *Hungary Savoring Goulash Capitalism,* Wall St. J., Nov. 17, 1989, at A10. The abolition of subsidies is also expected to increase unemployment and the number of bankruptcies. *The Road to a Market Economy, supra* note 76, at S3. Indeed, Hungarian food prices rose over 20 percent on January 8, 1990, after the state reduced subsidies to comply with an International Monetary Fund austerity program. *Food Prices Rise Over 20% in Hungary,* J. OF COM., Jan. 9, 1990.

78. U.S. DEP'T OF COM., *supra* note 66, at 5; *see also* Eichmann, *supra* note 1, at 286–87.

79. Bohlen, *Democratic Hungary Nibbles on Political Fringes,* N.Y. Times, July 9, 1990.

80. OPIC, *supra* note 33.

81. *See supra* note 66.

82. Plan Econ, Report, May 5, 1989, at 20. Hungary has incurred a debt of $20 billion, the highest per capita in eastern Europe. Istvan Tompe, then Deputy Finance Minister, estimated that Hungary will need as much as $2.5 billion in new loans for each of the next two or three years to continue meeting its current obligations. Carrington, *supra* note 77.

83. FIA, *supra* note 8, art. 32(1).

and the United States-Hungary Double Taxation Treaty prevent the double taxation of repatriated profits.[84] If the foreign partner sells all or part of his holdings, or if the joint venture is dissolved, the foreign share can also be freely transferred abroad, provided that the joint venture possesses the amount to be transferred in forints.[85] In addition, all foreign employees of the joint venture may transfer 50 percent of their aftertax personal income into the currency of their country of permanent residency.[86]

Irrespective of these liberal provisions, foreign investors still face two major problems with hard-currency repatriation. First, if Hungary were to experience a severe balance of payments crisis, foreign investors could encounter resistance in repatriating profits from domestic Hungarian sales. Second, although the Hungarian stock market is fully operational, its low level of liquidity could prevent an investor from easily selling shares in the company and repatriating its financial stake.[87] Therefore, foreign investors would be wise to rely primarily on hard-currency sales to guarantee hard-currency profit repatriation.[88]

As for the means of forint-based profit repatriation, joint ventures must follow the domestic legal provisions pertaining to foreign exchange transactions and the settling of accounts.[89] Thus, for those transactions where the foreign investor must convert from forints to hard currency, the overvalued official exchange rate must be used, making profit repatriation less attractive than in countries with market-determined exchange rates. Although the Hungarian government sets the exchange rate realistically and has allowed the forint to float against a basket of Western currencies since 1981,[90] the official rate still often diverges from the black market rate. For example, the black market rate exceeded the official rate by almost two-to-one in the fall of 1989.[91] Nevertheless, the spread between the

84. Convention for the Avoidance of Double Taxation, Feb. 12, 1979, United States—Hungary, art. 7(1), 30 U.S.T. 6357, 6369, T.I.A.S. No. 9560. Hungary's tax treaties do not contain antitreaty shopping provisions, allowing considerable flexibility in tax planning. Lieberman, Starr, Esser & Waters, *Investment in the Soviet Union and in Hungary: A Comparison of the New Soviet and Hungarian Investment and Tax Laws,* 23 GEO. WASH. J. INT'L L. & ECON. 1, 44 (1989).

85. FIA, *supra* note 8, art. 32(1); Company Act, *supra* note 6, § 9.

86. FIA, *supra* note 8, art. 33.

87. Greenhouse, *Lonely Days for Traders at Budapest Exchange,* N.Y. Times, Feb. 20, 1990, at D1. On the other hand, the Hungarian firm could list its shares on a Western exchange to create liquidity. Hungary's IBUSZ travel agency was the first Hungarian company to be listed on a Western exchange when it joined the Vienna stockmarket this year. Denton, *supra* note 10.

88. To a limited extent, some investors may repatriate profits through import substitution. The Ford Motor Company, for example, is investing in a car parts factory for export and will receive rights to import cars in exchange. Denton, *Budapest Puts Out Welcome Mat for Ford,* Fin. Times, July 7, 1990, at 3.

89. FIA, *supra* note 8, art. 31(1). However, cash contributed by a foreigner investor in hard currency may be maintained in a hard currency account and can be used freely for the duty-free importation of "means of production, spare parts and equipment for permanent use necessary for production." *Id.* art. 31(3).

90. Ter Borg & Lafeber, *Joint Ventures in Hungary,* 13 REV. SOCIALIST L. 317, 318–19 (1987).

91. Apple, Jr., *Capitalism Arrives in Hungary with a Vengeance,* N.Y. Times, Nov. 19, 1989.

official and black market rates is smaller in Hungary than in other Eastern European countries, and Hungary plans to reduce conversion problems by introducing partial convertibility of the forint by the end of 1991 or early 1992.[92]

V. Tax Laws and Concessions

Hungary has enacted a progressive tax regime for joint ventures and grants reductions in the tax burden through a complex incentive scheme.[93] If the joint venture does not qualify for tax reductions, it will have to pay a corporate income tax based on its profits for each calendar year at a rate of 40 percent for the first three million Hungarian forints (approximately U.S. $50,000) and 50 percent thereafter.[94]

To reduce this tax burden, the joint venture may avail itself of several significant tax breaks.[95] First, all joint ventures may import their means of production and equipment of permanent usage duty-free if these imports serve as part or all of the foreign investors' initial contribution.[96] Second, the joint venture may withhold 100 percent of the general turnover tax for all of its investments.[97] Third, the joint venture may receive a 10 percent rebate of the direct research and development costs.[98] Fourth, the joint venture may qualify for corporate tax concessions, all of which can be withheld from payment. For example:

(a) if the foreign share of the joint venture's original capitalization reaches 20 percent or five million forints, then the joint venture will receive a 20 percent reduction on its calculated tax;[99]

(b) if the joint venture meets the conditions in paragraph (a) above and pursues an activity of particular importance to the Hungarian economy (*see* Annex Two), then the Council of Ministers may grant a larger or longer tax reduction;[100]

92. Bandy, *supra* note 38 (ascribed to Ferenc Rabar, Minister of Finance); Denton, *Hungary Currency Timetable Set*, Fin. Times, May 17, 1990.

93. For an in-depth analysis of the Hungarian tax system, see Lieberman, Waters, Esser & Oleszczuk, *The New Hungarian Tax System*, TAX NOTES INT'L, June 1990, at 649; Liberman, Starr, Esser & Waters, *supra* note 84.

94. FIA, *supra* note 8, art. 14.

95. Tax breaks for foreign investors may be eliminated in the fall of 1990 because the Hungarian entrepreneurial class is pressuring the government not to discriminate in favor of foreigners. Lloyd, *Hungary's Tax Holidays Near End*, Fin. Times, June 27, 1990, at 3; *see also* Denton, *Hungarians Reject Shock Treatment for Economy*, Fin. Times, May 18, 1990.

96. FIA, *supra* note 8, arts. 18, 31(3). Otherwise, Hungary levies a 45 percent duty payable on all imports, except capital goods. OPIC, *supra* note 33.

97. FIA, *supra* note 8, art. 17.

98. Act IX of 1988 on Entrepreneurs' Tax, § 15 and annex no. 9 of the Act, *described in* Lieberman, Waters, Esser & Oleszczuk, *supra* note 93, at 653.

99. FIA, *supra* note 8, art. 15(2)(a).

100. *Id.* art. 15(4). Indeed, the larger the proposed joint venture, the more political leverage it will have to negotiate a reduced tax rate. In addition, foreign investors should attempt to negotiate this tax

(c) if over half of the sales receipts result from the manufacture of commodities or from the operation of a hotel built by the joint venture, the venture's initial capitalization exceeds twenty-five million forints (approximately U.S. $375,000), and the foreign share is at least 30 percent, then the joint venture will receive a 60 percent reduction on its calculated tax for five years after the first sale of its commodity or service and a 40 percent reduction thereafter;[101]

(d) if the joint venture meets the conditions in paragraph (c) above and pursues an activity of particular importance to the Hungarian economy (*see* Annex Two), then the joint venture will receive a 100 percent reduction on its calculated tax for five years after the first sale of its commodity or service and a 60 percent reduction thereafter;[102] and

(e) if the joint venture meets the conditions in paragraph (d) above and the foreign partner invests part or all of its profits in raising the original capitalization, then the joint venture will receive a tax concession equal to the amount of the profit invested to raise the capital, provided that "the net profit reaches the aggregate amount of the increase in capital and of the tax allowance related thereto."[103]

Joint ventures may also qualify for tax concessions if they invest in Hungary's lesser-developed regions.[104] These benefits include tax concessions equal to 20 percent of the initial investment costs and tax reductions of 50 percent in the first year of operations, 35 percent in the second year, and 20 percent in the third.[105] Tax benefits for different activities can be aggregated so long as they do not exceed the tax rate and cannot be carried forward to another year.[106]

VI. Customs Free Zones

Foreign investors may establish fully or partly-owned joint ventures in a customs free zone,[107] and will then be considered to be operating from a foreign territory for the purpose of customs procedures, foreign exchange rules, price

concession as early as possible, because they will have the most negotiating leverage while the joint venture is still in its planning stage, before any money is actually invested.

101. *Id.* art. 15(2)(b).

102. *Id.* art. 15(2)(c).

103. *Id.* art. 16. For example, the Ford Motor Company received a ten-year tax holiday on its $60–70 million investment in a car components plant as long as profits are reinvested. Denton, *supra* note 88. General Motors also received a ten-year tax exemption for its car engine factory. British Broadcasting Corporation, *Hungary: Tax Exemption for Raba-General Motors*, in SUMMARY OF WORLD BROADCASTS, Apr. 12, 1990, at EE/W0123/A/1.

104. Seven of the country's nineteen counties have regions qualifying for such treatment. OPIC, *supra* note 33.

105. *Id.*

106. Act IX of 1988 on the Entrepreneurs' Profit Tax, § 16, *described in* Lieberman, Starr, Esser & Waters, *supra* note 84, at 42.

107. Domestic Hungarian companies cannot establish themselves in such a zone. FIA, *supra* note 8, art. 37(1).

regulation, state control, and most foreign trade rules.[108] Such joint ventures may keep their books in convertible currency and must follow specialized accounting rules to distinguish their hard currency and foreign accounts.[109]

VII. Dispute Settlement

The parties to the joint venture agreement may stipulate that disputes will be settled by domestic or foreign courts or through arbitration. Otherwise, disputes will be settled according to domestic law.[110] In addition, the 1978 United States-Hungary bilateral trade agreement provides that joint ventures "may specify a place of arbitration in a country other than the Hungarian People's Republic or the United States of America that is a Party to the 1958 Convention for the Recognition and Enforcement of Foreign Arbitral Awards. Parties to the [joint venture] may provide for any other place or rules of arbitration."[111] Further, the American Arbitration Association and the Hungarian Chamber of Commerce have agreed upon an optional arbitration clause for joint ventures.[112]

VIII. Catchall Preferences

The Minister of Finance may grant preferences similar to those received in a customs free zone to a joint venture that "does not pursue an activity that comprises moving commodities across the state border."[113] Although generally worded, this provision was apparently intended to provide incentives for offshore banking by specifying that financial institutions wholly or partly owned by foreigners can be regarded as foreign financial institutions if located in a customs free zone.[114] Nevertheless, joint ventures established for domestic sales or services could apply for customs free status under this provision.

108. *Id.* arts. 37(1), 38. Customs free zones are not free from all foreign trade rules. In particular, these zones must comply with all international treaties that are legally binding on Hungary and with "import and export regulations specifically addressed to certain trade relation or commodities." *Id.* art. 39(1). In addition, joint ventures in customs free zones who wish to trade with those countries and commodities for which Hungary is bound by an international treaty must first receive the Commerce Minister's permission. *Id.* art. 39(2).

109. *Id.* art. 44.

110. *Id.*

111. Agreement on Trade Relations, Mar. 17, 1978, United States—Hungary, 29 U.S.T. 2711, T.I.A.S. No. 8967, at art. VIII(2). This treaty was recently renewed. *U.S. Renews Bilateral Trade Agreement with Hungary, White House Announces*, 7 Int'l Trade Rep. (BNA) No. 26, at 964 (June 27, 1990).

112. Memorandum of Agreement Between the American Arbitration Association and the Hungarian Chamber of Commerce, Sept. 7, 1984 (available at the American Arbitration Association in New York), *described in* Tiefenbrun, *Joint Ventures in the USSR, Eastern Europe, and the People's Republic of China as of December 1989*, 21 N.Y.U. J. INT'L L. & POL. 667, 701–02 (1989).

113. FIA, *supra* note 8, art. 43.

114. *Id.*

IX. Conclusion

Hungary offers foreign investors good potential for medium- and long-term returns on joint ventures. Although foreign investors may encounter substantial and enervating difficulties from the remnants of the Communist style of doing business, the continuing dissemination of market mechanisms should eventually alleviate most of the bottlenecks. Hungary has liberalized its legal and economic regulations more than almost any other Eastern European bloc country to approximate the workings of a market economy and can now serve as a manufacturing base for exports to the West or as a bridgehead to the opening of Eastern European and Soviet markets.

Annex One
Useful Addresses
for Prospective Investors in Hungary

Hungarian Chamber of Commerce
Foreign Investment Promotion
Service
H-1055 Budapest V
Kossuth L. Ter 6–8
phone: 36–1–153–3333
fax: 36–1–153–1285

Ministry of Trade
H-1055 Budapest
Honved U. 13–15
phone: 36–1–153–0000

InvestCenter (Hungarian Office for
Investment Promotion)
H-1051 Budapest V
Dorottya U. 4
phone: 36–1–118–6064
fax: 36–1–118–3732

Ministry of Finance
H-1051 Budapest
Jozsef Nador Ter 2–4
phone: 36–1–118–2066

Annex Two
Appendix
to
Article 15, para 2), subpara c) of Act XXIV of 1988
Activities of Outstanding Importance
to the Hungarian Economy

1. *Electronics:*
   (a) production of active, passive and electromechanic components;
   (b) production of computer (hardware) peripherals;

(c) production of electronically controlled telecommunication main and subcenters;
(d) production of instruments for robotics and services relating thereto;
(e) production of computer-aided design (CAD) systems; and
(f) production of electronical equipment, including electronical products for everyday use.

2. *Production of vehicle components.*
3. *Production of machinery.*
4. *Production of machinery and equipment for agriculture, food industry and forestry.*
5. *Engineering units:*
   (a) production of high precision cast, wrought or press-forged components and prefabricated elements;
   (b) production of components and spare parts of general use (quality fittings, valves, hydraulic and pneumatic components, advanced antifriction bearings and spare parts, high-strain resistant artificial material parts, technological constituents);
   (c) production of up-to-date joining fittings;
   (d) production of tools and appliances; and
   (e) production of technical ceramics.
6. *Packaging technology:*
   (a) production of package material and equipment; and
   (b) production of package machines.
7. *Production of pharmaceuticals, plant-protecting agents and intermediers:*
   (a) production of new pharmaceuticals;
   (b) production of new plant-protecting agents;
   (c) production of key-intermediers for pharmaceuticals & plant-protecting agents; and
   (d) production of veterinary preparations.
8. *Manufacture of products for agriculture and food developed for increase of exports and the decrease of imports effected in freely convertible currency.*
9. *Development of home protein stock.*
10. *Production of propagation and breeding material.*
11. *Field of materials and energy conservation:*
   (a) manufacture of products developed by a technology enabling the creation of smaller bulk and more up-to-date constructions (e.g., high-tensile component materials, high-grade clean materials, material-improving technologies);
   (b) production of units used for the permanent control and measurement of the qualitative parameters of technological specifications applied in process control;

(c) production of instruments for technologies concerning the improvement of the economy of waste profiles; and
(d) production of equipment for the economic utilization of big bulk by-products and waste material (e.g., in forestry, plant cultivation, stock breeding).

12. *Telecommunications.*
13. *Tourism:*
    (a) establishment and catering of establishments of thermal and medicinal baths if run by the investor;
    (b) reconstruction of manor houses declared historic buildings; and
    (c) establishment and catering of medium class hotel chains if run by the investors.
14. *Manufacturing of products developed on the basis of biotechnics or biotechnology.*